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IN THE

Supreme Court of the United States

OCTOBER TERM, 1934.

No. 582.

GUY T. HELVERING, Commissioner of Internal Revenue,
Petitioner,

v.

JAMES L. RANKIN, Executor of the Estate of Richard B. Turner, *Respondent.*

On Petition for a Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

BRIEF FOR RESPONDENT IN OPPOSITION.

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INDEX.

	Page
Opinion Below	1
Jurisdiction	2
Question Presented	2
Statutes and Regulations Involved	2
Statement	2
Argument:	
1. The decision below does not conflict with other decisions; it consistently applies established principles of law to the particular facts of this case	5
2. Particular lots of shares purchased in a marginal account are capable of definite identification for purposes of later sale	8
3. To hold a taxpayer may not designate the lot of stock purchased in a margin account which is to be sold is to deny him the right given other owners of shares of stock to pick and choose the shares they desire to sell	10
4. To hold that shares of stock held on margin are not capable of identification and that the "first in, first out" rule must be applied to determine the cost basis in all sales of stock purchased on margin, would be to construe the regulations as providing a conclusive instead of a rebuttable presumption, thus rendering same invalid and unconstitutional	11
5. The decision below injects no element of uncertainty in the administration of the tax law; it sustains a fair and reasonable rule permitting a taxpayer by sufficiently manifested intent and consistent action to designate and earmark a particular lot of shares which he desires to sell out of his margin account	13
Conclusion	14

TABLE OF CASES.

	Page
Cole v. Helburn, 4 F. Supp. 230	7
Commissioner v. Merchants & Mfgrs. Fire Ins. Co., 72 F. (2d) 408	6
Heiner v. Donnan, 285 U. S. 312	11
Horner v. Commissioner, 72 F. (2d) 407	6
Howbert v. Penrose, 38 F. (2d) 577	6, 13
Skinner v. Eaton, 45 F. (2d) 568	6
Snyder v. Commissioner, 54 F. (2d) 57	6
Snyder v. Commissioner, 73 F. (2d) 5	6, 11
Towne v. McElligott, 274 Fed. 960	6
United States v. Alpha Portland Cement Co., 257 Fed. 432, 434	8
Vawter, George, v. Commissioner, 31 B. T. A. No. 165	8

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OPINION BELOW.

The findings of fact and the opinion of the Board of Tax Appeals (R. 15-20) are reported in 26 B. T. A. 1204. The opinion of the Circuit Court of Appeals is reported in 73 F. (2d) 9.

Jurisdiction.

The decision of the Circuit Court of Appeals was rendered September 18, 1934 (R. 47). The petition for a writ of certiorari was filed December 15, 1934. The jurisdiction of this court is invoked under Sec. 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

Question Presented.

Whether 1000 shares of stock held on margin and sold in 1928 were, as a matter of fact, under the particular circumstances in this case, identified as the same lot purchased by the taxpayer earlier in the year.

Statutes and Regulations Involved.

The applicable provisions of the Revenue Act of 1928 and of the Treasury Regulations are set forth in the petition for the writ.

Statement.

Since this case involves primarily only a question as to the sufficiency of the evidence to support the taxpayer's contention respecting the fact of identification, a more complete summarization of the facts is presented below than in petitioner's statement.

In 1926 the taxpayer, Richard B. Turner, now deceased, received in distribution of his father's estate $20,000 in bonds (R. 30). He did not believe in bonds and wanted to change this inheritance into stock (R. 30). At his direction his attorney opened for him a margin account with a Philadelphia broker and with the proceeds of the bonds purchased on margin 1200 shares of United Gas Improvement stock at about 98 (R. 28, 30-31). He considered this purchase an investment (R. 37.)

For nearly two years Turner had no further marginal transactions in this or any other stock (R. 28, 31). At the

beginning of 1928 his margin account showed 1500 shares of U. G. I. stock long, the additional 300 shares representing a 25 per cent stock dividend on November 22, 1926 (R. 28). These 300 shares, received as a stock dividend, were sold on May 8, 1928 (R. 29), and there is no dispute between the parties as to the basis used in computing the profit thereon.

During 1928 Turner was kept away from his business by a serious illness and began to play the market as a pastime (R. 31, 38). Beginning on March 14, 1928, and continuing throughout the remainder of the year he bought and sold on margin in the same account a large number of stocks, the transactions usually being in 500 and 1000 share lots (R. 31-32).

Included in these speculative (R. 37) transactions of 1928 was a purchase of a lot of 1000 shares of U. G. I. stock on June 8, 1928, at about 143¼ (R. 28-29) which he sold (as claimed by respondent and as held by the court below) in two lots of 500 shares each on October 22 and November 7 at about 147½ (R. 29).

The uncontradicted evidence showed that Turner was extremely sentimental about keeping the original 1200 shares considered as an inheritance from his father (R. 30, 34-35); that he at all times intended to keep those particular shares and to sell in 1928 the 300 shares received as stock dividend and the 1000 shares purchased in June of that year (R. 32-33); that he fully communicated that intention both to his business associates (who handled his affairs for him during his illness) and to the broker (R. 33, 35); that his decisions to sell were reached on that basis (R. 36); that his books and records were kept and his tax return made on that basis (R. 38); that he at all times and repeatedly emphasized the distinction between the 1200 shares which he was holding as an investment and the 1000 shares which he bought and sold as a speculation (R. 33-38); and that he did everything in his power and control to effect that intention. Both lots of stock having been bought on margin

he did not from the nature of things have physical custody and control of the certificates, but he saw to it that the broker was informed as to which shares he was keeping and which shares he was selling (R. 33, 35). The Board found (R. 18) as a fact:

> "The decedent always intended to retain the ownership on margin of 1200 shares of the United Gas Improvement Co. stock since he had faith in the company and desired to hold that in lieu of the bonds which he had received from the estate of his father."

The Commissioner of Internal Revenue held that the shares sold in October and November, 1928, were not capable of identification by certificates as being from the lot purchased in June, 1928, and that the so-called "first in, first out" rule of Art. 58, Regulations 74 (quoted in the petition herein) should be applied to determine the cost of the shares sold (R. 17). He thereby arbitrarily determined that the 1300 shares sold in 1928 consisted of 1040 shares out of the original 1200 shares plus 260 of the shares received as a stock dividend, and that the total basis for computing profit or loss should thus be reduced to $99,735 and the taxable profit correspondingly increased from $25,933.50 to $92,864 (R. 17-18). This arbitrary method of computing the profit in turn necessitated a very complicated, elaborate, and equally arbitrary prorating of the cost of the 1200 shares originally purchased as set forth at R. 17-18.

The Board sustained (R. 18-20) this arbitrary determination of the Commissioner and completely ignored the evidence that Turner's *intention* not to sell the 1200 shares purchased in 1926 had been *communicated* to the broker, and that everything had been done by the taxpayer which, in the nature of the case, could in fact be done by him to identify and specify the *lot* of shares from which the October and November sales were made.

The Circuit Court of Appeals reversed (R. 44-47) the Board, holding that full effect must be given to the commu-

nication of the taxpayer's intention to the broker respecting the specific lots to be sold and not to be sold, which amounted, under the principle established in several previously decided cases (which were discussed), to identification in fact of the lot from whence came the shares sold. The court held (R. 46-47):

> "The Commissioner, the Board of Tax Appeals affirming him, ignored this action of the petitioner on the theory that the U. G. I. stock, which from time to time he purchased on margin, and later sold, could be identified only by certificates; * * *
>
> That was error. What was bought and sold were shares, not certificates. * * * Shares as distinguished from certificates are property subject to conversion and capable of identification. * * *
>
> The petitioner's instructions excluding from sale the shares first purchased were in effect an identification of the shares later sold as those last purchased.
>
> While the petitioner, in identifying his shares, might have been more specific in his instructions to his broker, those he gave stand uncontradicted; indeed, they have not been questioned. We think they were enough to take the case out of the rule and that, in consequence, the deficiency tax in issue is invalid to the extent that it is based on gains in sales of U. G. I. shares reckoned on the purchase price of the original 1200 shares."

ARGUMENT.

1. *The decision below does not conflict with other decisions; it consistently applies established principles of law to the particular facts of this case.*

Petitioner does not urge that there is any conflict in fact between the decision below and the decisions in the other cases cited, but that such decision merely "conflicts in principle" with such cases. It is not alleged that any court has given a negative answer to the question which petitioner asserts is here presented. By reason of the marked difference in the factual situations it cannot be said that the deci-

sions of the several circuit courts are in conflict. The court below itself found no difficulty in distinguishing the other cases on their facts; it did not indicate any disagreement with the principles of law established by other cases.

As pointed out in the petition, the so-called "first in, first out" rule of the regulations has frequently been considered and applied by the courts. *Howbert v. Penrose*, 38 F. (2d) 577; *Skinner v. Eaton*, 45 F. (2d) 568; *Snyder v. Commissioner*, 54 F. (2d) 57; *Horner v. Commissioner*, 72 F. (2d) 407; *Commissioner v. Merchant's & Mfgrs. Fire Insurance Co.*, 72 F. (2d) 408; *Snyder v. Commissioner*, 73 F. (2d) 5. See also *Towne v. McElligott*, 274 Fed. 960. The validity of the rule, when construed as a presumption as to the property sold *where no evidence is offered as to identity of lots and dates of purchase*, is now hardly open to question. *Skinner v. Eaton, supra.*

The court below, consistently with these prior decisions, ruled identification to be "a matter of fact" (R. 45), and upon a careful consideration of the evidence held it to establish that Turner as a matter of fact had identified the stock sold in October and November, 1928, as being the lot purchased in June, 1928. The case thus turned on the weight and sufficiency of the evidence to support the Board's conclusions, and the Board was reversed because of its failure to give effect to the communication of Turner's intention to his broker respecting the specific lots of stock to be sold and not to be sold, and to the corroborating evidence as to identification.

The court did not, as suggested at page 7 of the petition, allow "a mere declaration of intention to take the place of the factual identification required by the regulation"; it was careful to point out that under the decided cases, "his 'intention' • • • clearly was not enough to take the case out of the rule" (R. 46), and that there was "something else" in this case (R. 45). This "something else" was stated (R. 46) to be:

> "What Turner did in this case, acting and speaking through his attorney, was to communicate to his broker

his intention to hold for investment the shares of U. G. I. he originally purchased. His decisions to sell like shares later purchased were reached on that basis; his books and records were kept on that basis; and, accordingly, his income tax return was made on that basis."

There is no conflict between the decision below and that in *Skinner v. Eaton, supra*, such as suggested at page 5 of the petition. That case did not involve stock purchased on margin. In that case there was some evidence of the taxpayer's intent, *expressed several years previous to the sale*, to retain his first purchases but no proof that any effort was made to carry this intention into effect or to keep a record of the stocks acquired and sold. Here Turner communicated his intent to the broker and *did everything that it was possible to do to identify the lot of shares to be sold* and especially to preclude the sale of the lot purchased in 1926. The *Skinner* case did not hold, nor even suggest as *dicta*, that shares of stock purchased on margin *could not* be identified, or that shares could *only* be identified by certificate numbers.

Howbert v. Penrose, supra, is not only consistent with the decision below, but seems to go further and to hold that the declared intention of the taxpayer as to what stock is to be sold is sufficient in itself. The two *Snyder* cases did, however, involve marginal transactions. They were decided by the same court which decided this case, and the second *Snyder* case was decided the very same day as the present. The court distinguished those cases on their facts and it cannot reasonably be contended the two decisions thus simultaneously rendered are in conflict. Neither the *Horner* nor the *Merchants* cases involved marginal transactions and there can be no conflict. They are cases where the stock actually identified as sold was not that intended to be sold. *Cole v. Helburn*, 4 F. Supp. 230, did not involve a marginal sale, and was simply a case where no instructions were given the broker as to what stock to sell.

It is significant that the Board of Tax Appeals has cited the decision below with approval and as being consistent with the previously decided cases by the courts and the Board. See *George Vawter v. Commissioner*, 31 B. T. A. No. 165, decided Dec. 14, 1934.

Here we have clear and convincing evidence as to just what property was to be sold. The court was correct in holding there is no reason for applying the presumption of the regulations. By the very terms of Art. 58 the presumption only applies where the "identity of the lots cannot be determined."

It is a most unreasonable contention advanced here by the Commissioner that Turner must be found to have sold the stock purchased in 1926 when the evidence is conclusive that he did not want to sell this particular stock and did everything he could do to keep from selling it. As well observed in *United States v. Alpha Portland Cement Co.*, 257 Fed. 432, 434, "The mind staggers over giving sanction to a finding that something is true which we know is not true."

2. *Particular lots of shares purchased in a marginal account are capable of definite identification for purposes of later sale.*

The Government in this petition again renews its discredited contention that shares of stock are not capable of identification except by certificates. *The Government has never been sustained by any court in such contention,* and cites no cases supporting such a view. The decisions are the other way. As pointed out in *Snyder v. Commissioner*, 73 F. (2d) 5, what are bought and sold in a margin account are *shares of stock,* not certificates which are mere evidence of title to the shares which constitute the property owned. The court there held:

> "From the petitioner's statement of fact and his position on the law, it is obvious he has confused identification of shares and identification of certificates in

transactions of sale. The rule deals with the sale and identification of 'shares of stock in a corporation,' not with sale and identification of certificates. Shares of stock and certificates for shares of stock are different legal entities. Shares of stock 'are intangible and rest in abstract legal contemplation'. They are the interest or right which the owner has in the management, profits and assets of a corporation. 14 C. J. Secs. 506, 509. Though incorporeal, they nevertheless are property and are the subject of conversion. 14 C. J. Sec. 509; 7 R. C. L. Sec. 166; *Skinner v. Eaton, Collector,* 45 Fed. (2d) 568. A certificate of stock, on the other hand, is the symbol or paper evidence of the ownership of shares; it is not the stock itself. It is merely written evidence, and then only *prima facie* evidence, of the ownership thereof by the person designated therein and of the rights and liabilities resulting from such ownership. 14 C. J. Secs. 698, 701, 702, 707, 709, 710, 1043. *Howbert v. Penrose,* 38 Fed. (2d) 577, 579. A stockholder may prove his ownership of shares by evidence other than that of the certificate, 14 C. J. Sec. 1272; and he may dispose of his shares and surrender his title therein by sale accompanied with delivery of a certificate in his name which he has endorsed with with a blank assignment and power of attorney authorizing the transfer. 14 C. J. Secs. 1033, 1050; 7 R. C. L. Secs. 239, 243. As between seller and buyer the shares pass by mere delivery of the certificate, so endorsed, though the transfer as between the new owner and the corporation is not complete until made on the books of the corporation. When the new owner of the shares sells them without first having them transferred to himself on the books of the corporation and makes delivery by handing over the certificates so endorsed in blank by the original holder and starts it on its wanderings through the 'street', the shares may go in one direction and the certificates in another; the shares, however, always being represented (in the rapid shifting of certificates between brokers) by a like certificate in the name of another, with endorsement in blank, held for the owner. Then 'ownership follows the owner, not the certificate'. *Howbert v. Penrose,* 38 Fed. (2d) 577, 579."

At page 9 of the petition the Commissioner urges that since "shares of stock bought on margin are not represented by identifiable certificates, it is utterly impossible to identify them." Significantly the regulation only applies where "the identity of the *lots* cannot be determined." Of course a lot of stock bought on margin is identifiable by the records of the broker and of the taxpayer. Each transaction is earmarked. There is no more difficulty in identifying specific lots of shares bought on margin than the costs of different lots. The same records show both lot and the cost of the same. The man in the street would certainly not conceive of any such difficulty in identification as the Commissioner purports to find.

3. *To hold a taxpayer may not designate the lot of stock purchased in a margain account which is to be sold is to deny him the right given other owners of shares of stock to pick and choose the shares they desire to sell.*

The absurd result of any such rule as the petitioner seeks to establish in this case demonstrates the correctness of the decision below. It cannot be disputed that a taxpayer owning shares of stock for which he has certificates may pick out and sell those having a cost to him which will produce a gain or loss as the taxpayer may desire. Nor can it be disputed that a taxpayer having different marginal accounts in each of which he has purchased lots of the same stock may likewise pick out a lot in a given account which will produce a gain or loss as may be desired. The Commissioner could not claim the designation of a given account was not a sufficient identification of what lot was sold. But the Commissioner contends that where more than one lot of the same stock are purchased in the same marginal account the taxpayer is to be precluded from identification of a particular lot sold, and that such a taxpayer is to be denied the right, afforded to all other classes of taxpayers, to exercise his own free will in deciding which lot and what property he wishes to sell.

Where, as in the present case, the taxpayer does all that can be done in the circumstances to identify the lot to be sold, where he not only has a mental intent respecting the stock to be sold but crystalizes this intent into action by directing his broker which lot to sell and which to hold, where his intention of what is to be sold is evidenced by contemporaneous overt acts, and is thus capable of real proof, there is every reason for holding that the taxpayer has successfully identified the shares and is entitled to the same basis as though he had certificates to evidence his shares rather than a chose in action of a different nature. The obvious purpose of the regulation is to give a rule for determining a factor in computing taxable profit in the absence of proof as to such factor—but not to deny the right of proof.

4. *To hold that shares of stock held on margin are not capable of identification and that the "first in, first out" rule must be applied to determine the cost basis in all sales of stock purchased on margin, would be to construe the regulations as providing a conclusive instead of a rebuttable presumption, thus rendering same invalid and unconstitutional.*

If the government is correct in its contention that the "first in, first out" rule must be applied in all sales of stock in a marginal account the obvious effect is to preclude the taxpayer from proving what shares and what property he intended to and did sell. Thus the regulation, when applied in such cases, will establish a conclusive and not a rebuttable presumption. If so construed it is clearly invalid and unconstitutional under *Heiner v. Donnan*, 285 U. S. 312.

That the regulation does not establish a conclusive presumption in marginal transactions and is therefore valid was ruled in *Snyder v. Commissioner*, 73 F. (2d) 5, where the court held:

"The usual ground of attack has been that the rule is arbitrary and capricious and therefore in contravention of the due process clause of the Fifth Amendment to the Constitution. This court has held that while the rule is, from the very nature of the situations to which it applies, fixed and peremptory and in that sense arbitrary, it is, from the latitude of its words, not inflexible or capricious and therefore is not unreasonable. Since this pronouncement, *Heiner v. Donnan*, 285 U. S. 312, has been decided. On that case the petitioner here takes a new stand. By that decision the Supreme Court held that Section 302(c) of the Revenue Act of 1926, creating a presumption that gifts made within two years of the donors' death were made in contemplation of death, was unconstitutional. The petitioner says that the rule which, on failure to identify shares sold, affords a presumption that the shares sold were those first bought is likewise unconstitutional. There is really no analogy between the provision of the statute under consideration by the Supreme Court in the *Heiner* case and the terms of the rule here under discussion. There the presumption was 'conclusive' and made so by the statute. Here the presumption is rebuttable, hence constitutional. *Cockrill v. California*, 268 U. S. 258, 261; *Yee Hem v. United States*, 268 U. S. 178, 183-184; *Mobile, J. & K. C. R. R. v. Turnipseed*, 219 U. S. 35, 42-43. The taxpayer is given every opportunity to identify the shares he has sold and to prove his loss or gain accordingly. Indeed, the rule comes into operation only 'when' the identity of the shares sold cannot be determined, which usually happens when the owner in ordering their sale has failed to identify the lots in which they were purchased. In such case there must be some way of determining for the benefit of the taxpayer his losses or gains in his taxable transactions and similarly, of determining what taxes the government is entitled to exact. Except for this rule or some similar rule, efficiently to administer the revenue act, a vast multitude of potential taxpayers dealing in the purchase and sale of shares on margain and actually making profits would escape taxation because of their inability or disinclination to identify the shares sold and the government would lose the taxes which the statute imposes."

The court therefore clearly indicated that the regulation would be invalid if construed, as here contended by petitioner, to preclude identification. The same conclusion was reached in *Howbert v. Penrose, supra,* where the court said:

> "The Government has not the power to say that if the taxpayer sells any of his holdings in a particular company, it can say conclusively that he sold the stock bought at the cheapest price or the shares purchased before or after a certain date. He has the right to decide that himself."

5. *The decision below injects no element of uncertainty in the administration of the tax law; it sustains a fair and reasonable rule permitting a taxpayer by sufficiently manifested intent and consistent action to designate and earmark a particular lot of shares which he desires to sell out of his margin account.*

Where a taxpayer, as in this case, by clear and convincing evidence establishes the lots of marginal stock to be sold, that is sufficient identification; where there is no such clear earmarking of the lot sold there is no identification. That seems to be the principle of law involved in this case. It is hard to see how any such holding can possibly, as petitioner suggests, "create considerable confusion and doubt as to the proper rules to be applied in these cases".

Obviously no principle can be formulated which will relieve the taxing officials and the Board from considering evidence in particular cases as they arise, or from their duty to make findings of fact as to whether the taxpayer did or did not by properly *manifested* intent and overt acts designate the lot of shares in his marginal account to be sold.

Conclusion.

No proper case is here presented, under the provisions of Rule 38 of this court, for the granting of the writ prayed for. It is submitted that the decision below is correct and is in harmony with the decided cases. The petition should be denied.

Respectfully submitted,

John W. Townsend,
Counsel for Respondent.

January, 1935.